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The Soviet Economy

Proposed Briefing

Office of Economic Research
25 August 1970

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The Soviet Economy

Introduction

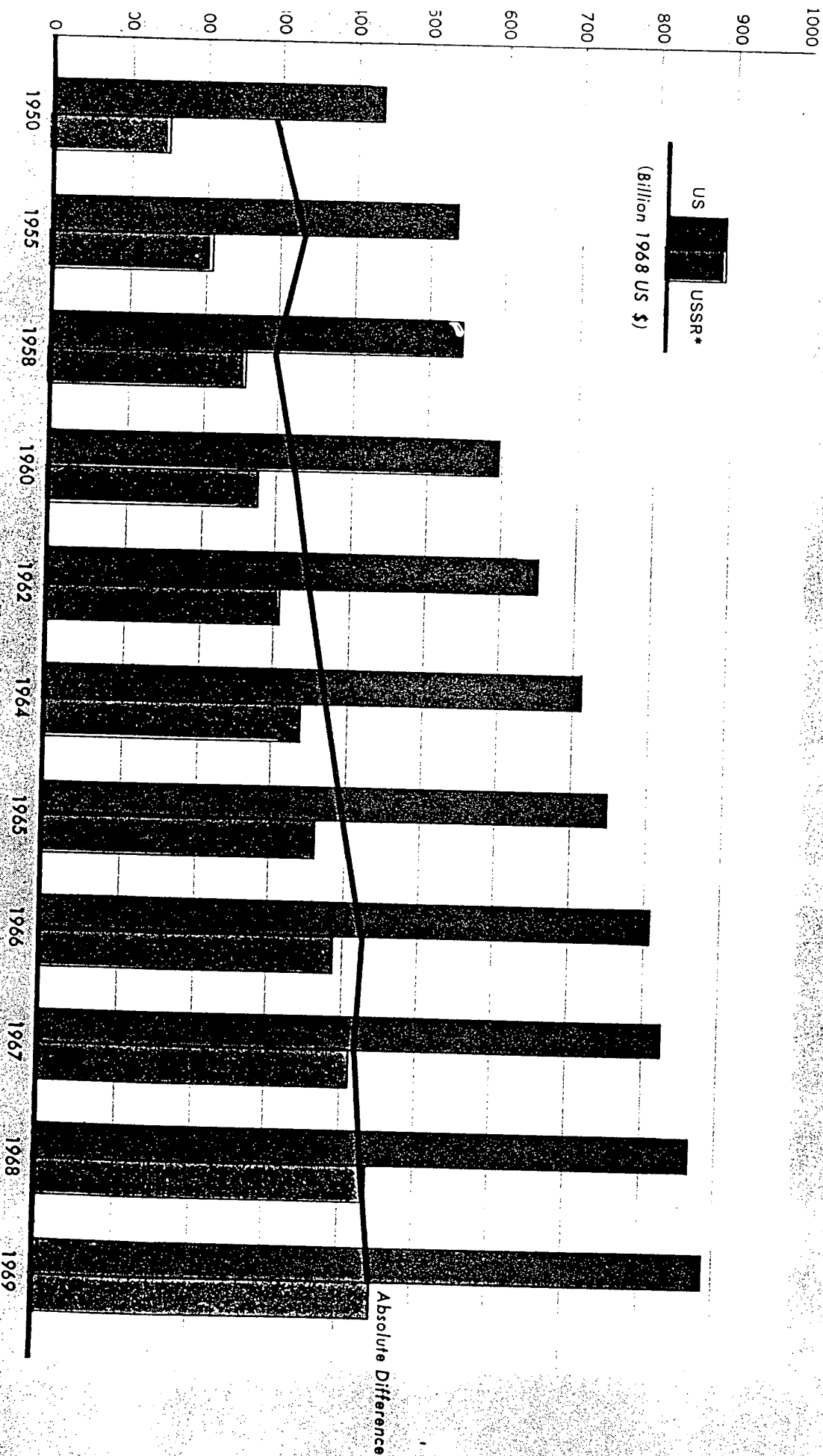
A slowdown in Soviet economic growth during the 1960's has tarnished the image of Communism as the "Wave of the Future." Soviet party leaders no longer confidently boast, as they did in Khrushchev's day, that the USSR's economy is on the brink of overtaking that of the US.

However, it is important to realize that the Soviet economy continues to expand, supporting rapid industrialization, a rising level of living, and maintenance of a strong military and scientific establishment.

Stages of Growth (Chart 1)

We can review recent comparative economic history with the benefit of our first chart, which shows total output in the US and USSR since 1950. If you look at the rate of increase of Soviet GNP reflected in the first three brown bars (1950, 1955, 1958), you can see that the decade of the 1950's was one of very rapid Soviet growth. The absolute size difference between the two economies actually narrowed for a few years.

US and USSR: Gross National Product, Selected Years, 1950-69



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*Geometric average comparison

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Excluded from automatic
downgrading and
declassification

In the 1950's, following the death of Stalin, Khrushchev resolved the resource allocation problem in favor of investment and consumer welfare.

Defense expenditures at the end of this decade were almost the same level as at the beginning.

Consumer programs -- serious attention to improving the quality of the Soviet diet and housing in particular -- saw consumption outlays move up 6 percent a year.

But the apple of Khrushchev's eye was investment, which he saw as the key to rapid economic growth and Soviet prestige. Investment outlays moved up 12 percent a year.

As the 1950's came to an end, there was a significant deceleration in Soviet growth. The primary reasons for this are four in number:

1. A slowdown in agriculture following the expansion period of the so-called new lands.
2. A drop in the growth of labor and capital inputs. Labor force additions at this time were adversely affected by the low birth rates of World War II. Moreover, the USSR cut the work week from 46 to 41 hours. The high rate of capital formation could no longer be sustained.
3. Managerial problems grew rapidly as the highly centralized bureaucratic system of the USSR tried to shift gears to absorb the new technology.
4. Defense spending increased. Advanced weapons systems came into production, R&D costs rose sharply,

left the scene, the marshals received a higher budget priority all around.

The slowing trend of Soviet growth continued throughout the 1960's. Indeed, during 1969 Soviet GNP increased only 2.1 percent, or less than half the rate maintained during the preceding several years. In the first six months of this year the Soviet economy posted a good recovery from the poor performance of 1969. But because economic activities were hampered by unusually bad weather in the first quarter of 1969, the subsequent increase in production contains a large element of rebound. Production this year has been stimulated to some degree by campaigns to commemorate the Lenin centenary and to complete the 1966-70 plan period with a flourish.

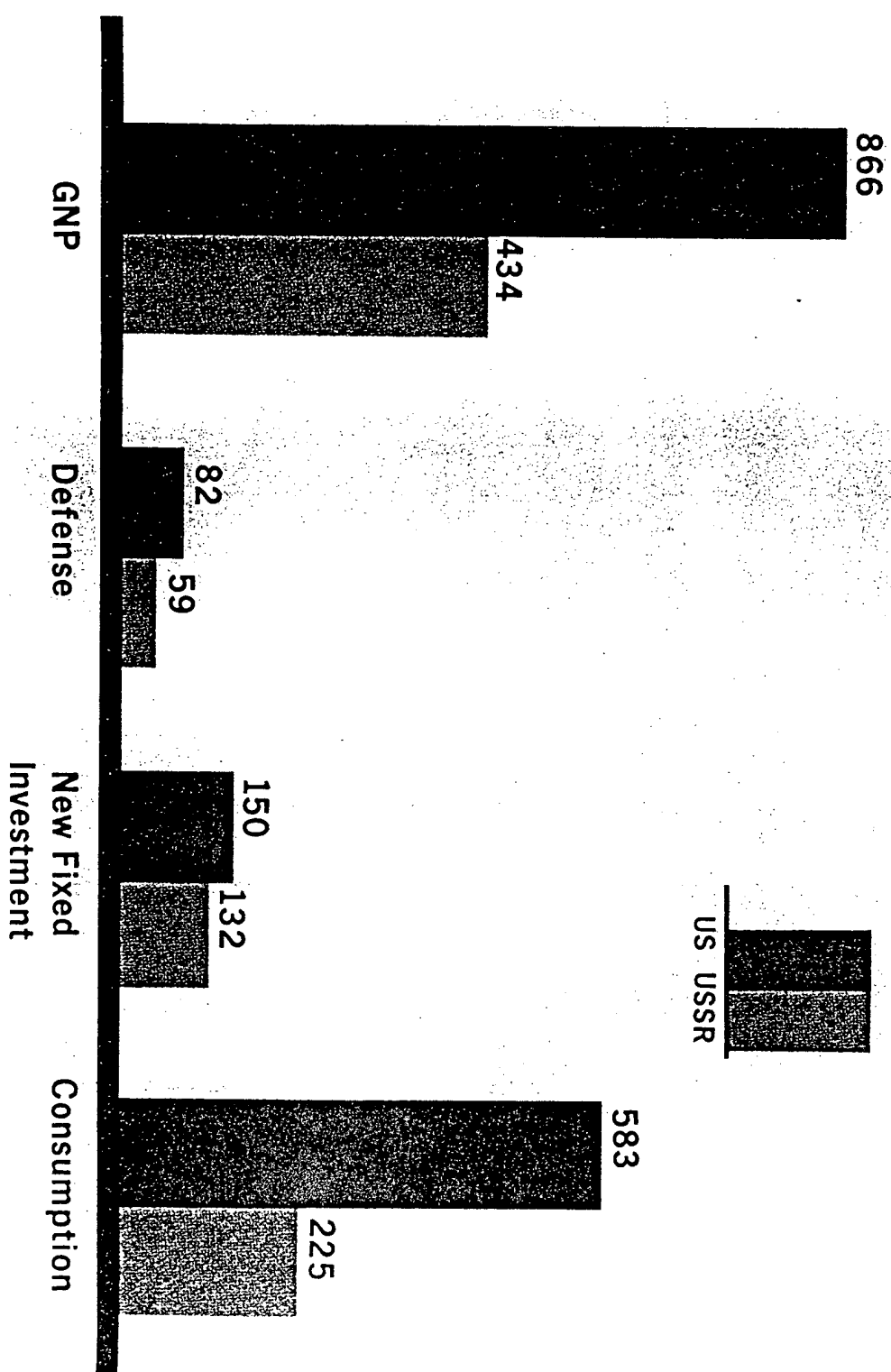
In recent years, the Soviet Union has not been gaining on the US. Growth rates have been roughly the same in the two countries. As a result, the Soviet economy remains about half the size of ours, and the absolute gap in size of GNP has been widening in our favor.

Allocation of GNP (Chart 2)

To move along, the USSR allocates its total output much differently than does the US. Their allocations stress the elements of national power; our allocations stress consumer welfare. Our chart shows:

1. As for consumption, or what the man in the street receives, a Soviet population one-sixth larger than ours gets perhaps 40 percent of what is spent here. Per capita, this means a bundle of goods and

US and USSR: Gross National Product by End Use, 1968 Billion 1968 US Dollars



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change course in the allocation

2. Their outlays for new fixed capital are about 85 percent of the US figure in absolute terms. This concentration reflects the continued growth orientation of the Communist leaders.

3. Finally, the Soviet defense and space outlays -- in dollar values -- equate to nearly three-fourths of what the United States spends on such programs.

The current picture (1970) indicates some marginal shifts in the allocation pattern.

1. Heavy industry investment is receiving a significant boost in funds compared to a year earlier.

We do not expect this infusion will do much to spur output, for reasons I will go into later.

2. We see a 3 to 4 percent increase in defense and space outlays, which would be a slower rate of growth than in 1969.

3. However, the pace of improvement in consumer welfare will probably be slightly less than that achieved in 1969 -- perhaps 3 percent.

A new five-year plan is being drafted for 1971 to 1975. Delay in publishing the plan seems to be due, in part,

to disagreement within the leadership on priorities. To date, only the agricultural targets for 1975 have been announced.

Nevertheless, it would be surprising if the present compromise

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leadership were to radically change course in the allocation pattern.

Finally, we are persuaded that tinkering with allocations at the margin is a most unpromising way to get the Soviet economy moving again at the growth rates achieved in the 1950's.

Military Expenditures -- Root Problem or Bugaboo? (Chart 3)

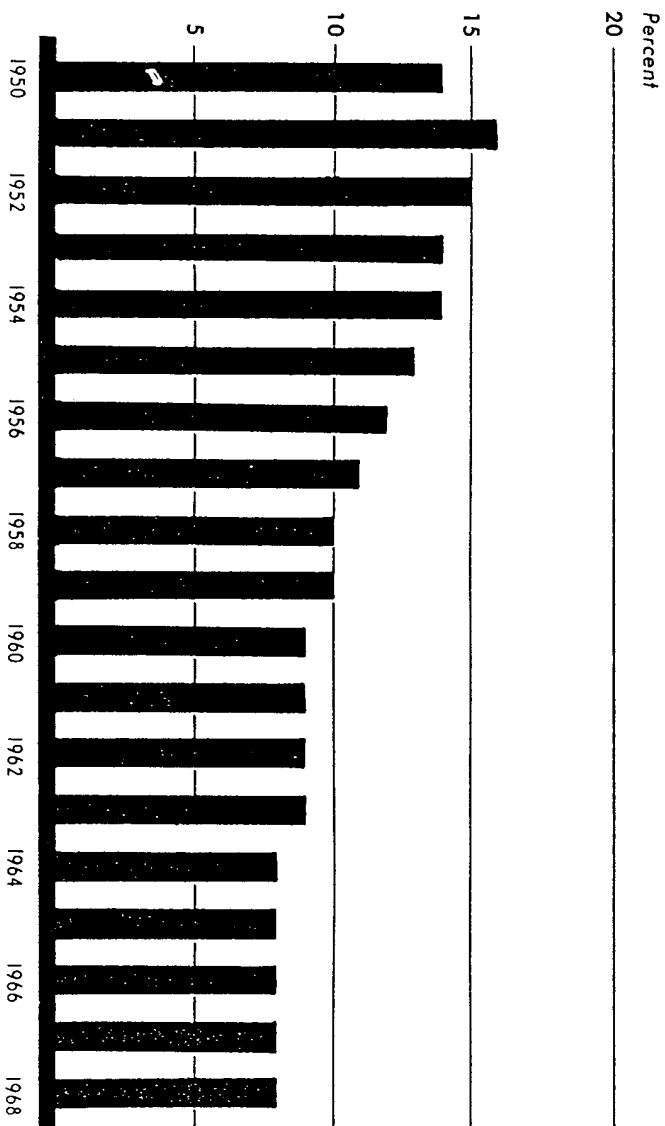
In looking for root causes of the slowdown in Soviet growth, the burden of defense outlays is often cited as the key factor. There is no doubt that in an economy as taut as the USSR's, where plant, equipment and skilled manpower are in short supply, that military programs represent a direct drain on scarce resources.

Although these are significant costs, the burden of Soviet outlays for military and space programs must be measured against the background of an increasing national product. Our chart shows the declining share of defense in Soviet GNP. You can see that the military claim to total output, measured in rubles, has fallen from about 15 percent in 1950-52 to 8 percent in recent years.

This suggests that the defense burden is not as critical as it once was. We also note that Soviet output is now so large that even moderate rates of growth should provide the leadership with some leeway to increase defense outlays if they so desire. Even if there were to be a further slowdown

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USSR: Share of GNP Devoted to Defense and Space Programs (at factor cost, in ruble prices)



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in economic growth, the USSR will have the capability to maintain a strong and increasingly sophisticated military establishment.

The R&D Effort (Chart 4)

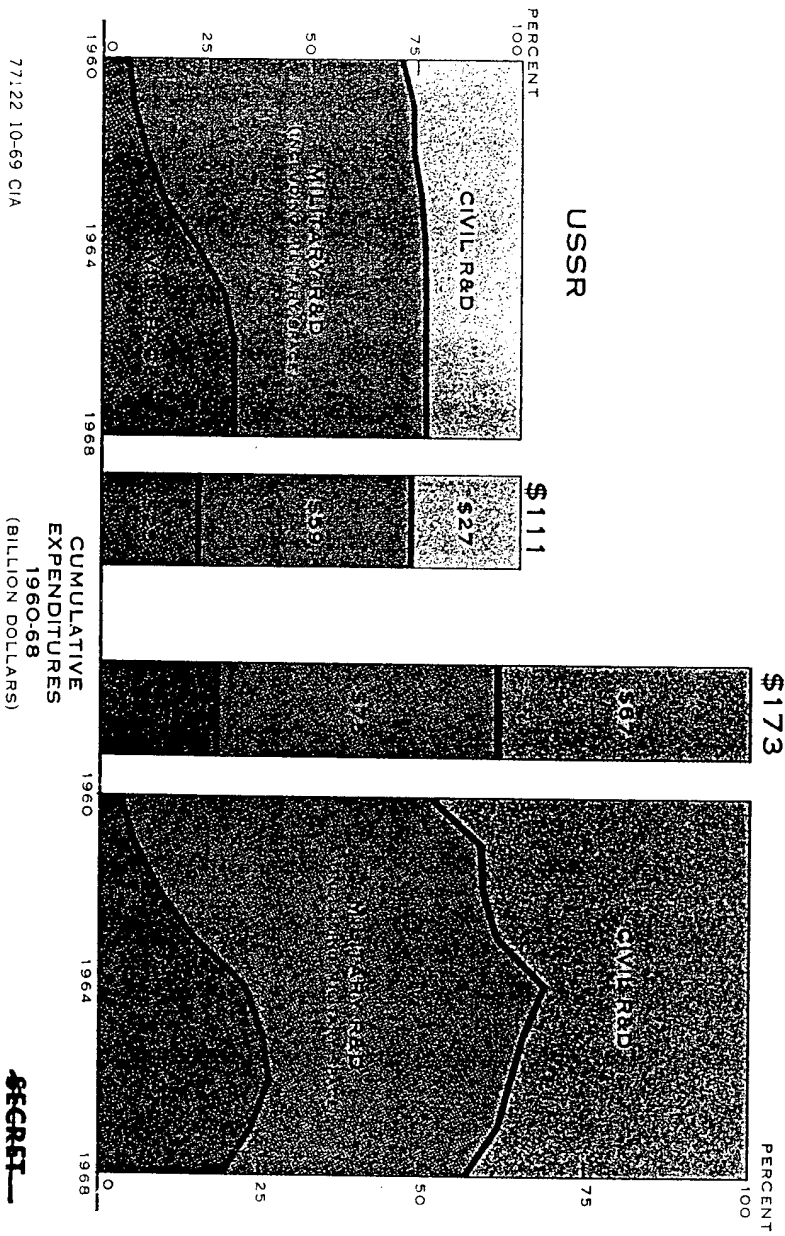
Within the defense spending category, the area which is undoubtedly causing the greatest pinch on the civilian economy is research and development. Since 1966 spending for military research and development has been growing much faster than total defense spending. Furthermore, Soviet R&D is much more oriented to military objectives than is the case in the US. In fact, during the 1960's about three-fourths of the Soviet research and development resources were engaged in military and space projects, and only one-quarter in civilian projects.*

Soviet authorities are now more aware than ever of the adverse effects the lack of civil R&D spending has had on economic progress, and efforts are currently under way to improve the situation. The Soviets have identified three approaches: First, an increase in the expenditure level for civil R&D is to take place during the next Five-Year Plan (1971-75). Second, a change in emphasis from research to development is being called for. By Soviet admission, this

* In this context, "space" includes both military and civil space outlays.

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SOVIET AND US EXPENDITURES FOR RESEARCH AND DEVELOPMENT AND SPACE 1960-68



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will move the USSR closer to US practice, which the Soviets admit is more efficient. Third, improvements are planned for the overall administration of civil R&D efforts to eliminate bottlenecks and speed economic returns from R&D expenditures. Major changes are planned in every stage of the R&D process, from initial planning to final pricing of new products.

Soviet Agriculture

I turn now to the subject of Soviet agriculture. Last year, 1969, again pointed up the precarious nature of Soviet agricultural output and its dependence on good weather to achieve a satisfactory level of output. We estimate that agricultural production in 1969 declined by over 4 percent. This year we expect to see a substantial recovery. With very favorable weather thus far, prospects are for a record grain harvest.

But there are more problems than just weather for the Soviet agriculturalists to cope with. They have been hard pressed to increase the supply of food to meet the needs of a moderately growing population for an adequate diet. For example, USSR foreign traders earlier this year bought meat in Australia, New Zealand, France and some other countries, showing clearly the inadequate nature of Soviet meat production.

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Further, agriculture still ties down an inordinately large population of the labor force, with 40 million people (one-third of the total) still engaged in tilling the soil. This is 10 times the number required in the US to feed our people adequately and permit a large flow of agricultural exports.

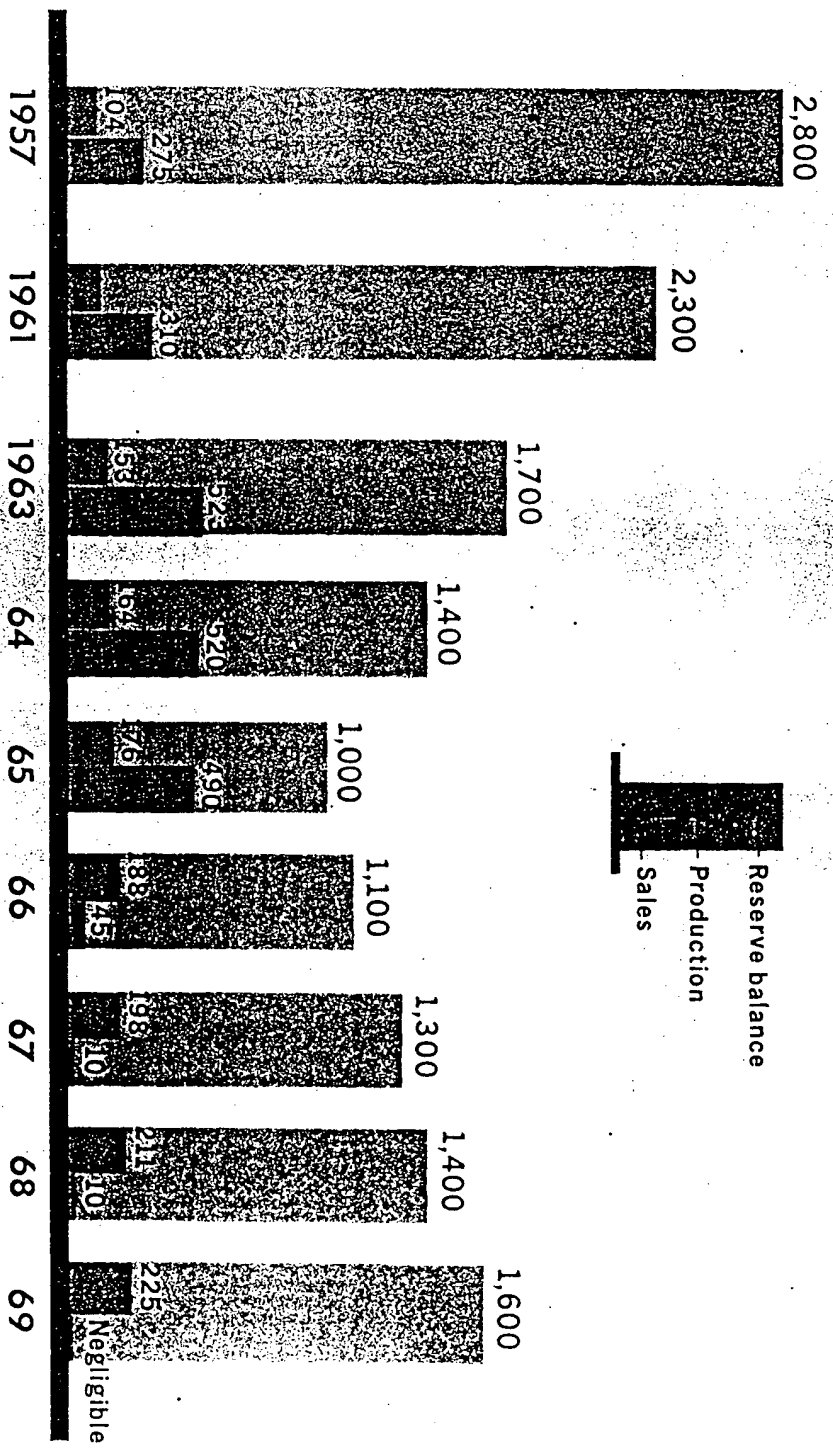
Agriculture was starved for investment funds under Stalin. But in recent years, Khrushchev and his successors have put in the rubles, to the point where agriculture receives about one-sixth of total fixed investment. This substantial injection of investment is to continue, according to the new five-year plan target (1971-75) for agriculture. Although output has been raised and diets improved somewhat, the response of output to these measures has been discouraging to the Soviet planners.

Gold (Chart 5)

One consequence of fluctuating agricultural output is a need for the USSR to mine, and to hoard, its high-cost gold. In the event of a crop disaster, Soviet gold can buy the needed Western grain to keep the population fed. This happened most recently following the crop failures in 1963 and 1965, when, as the chart shows, Soviet gold reserves dropped from about \$2 billion in 1962 to about \$1 billion in 1965.

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USSR: Gold Production, Sales, and Reserves Million US Dollars at 35 Dollars Per Troy Ounce



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The USSR has sold almost no gold since 1965, but has slowly built up its reserves to about \$1.6 billion at the end of 1969. The USSR now produces about \$225 million in gold each year, despite very high production costs. It has tried to balance imports with exports, and when a small deficit appeared, the Soviets have preferred to increase their borrowings in the West rather than to sell gold.

Soviet Trade with the West (Chart 6)

The USSR conducts about two-thirds of its foreign trade with Communist countries, but trade with the Industrial West has expanded rapidly; last year it was about double the level of 1960, or \$2 billion each way. Oil exports are the largest hard currency earner, accounting for one-quarter of total exports to the West. However, Soviet oil exports dropped off in 1969 and are not expected to increase this year. In order to boost hard currency earnings, the Soviets are increasing substantially exports of other items such as diamonds and platinum.

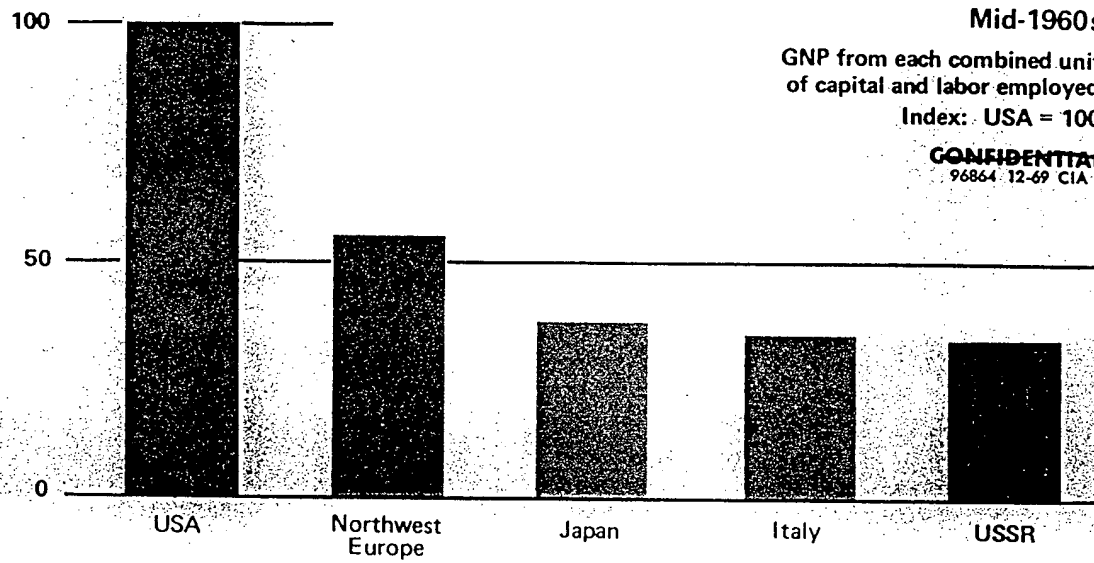
Heightened Soviet interest in trade with the West is a reflection of the large technological gap which exists between the USSR and the West, particularly the United States. The chart shows that, for a given input of capital and labor, output in the USSR is about one-third that of the United

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Relative Levels of Technological Development --
Mid-1960s

GNP from each combined unit
of capital and labor employed
Index: USA = 100

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States. It is about equal to that of Italy, and significantly behind that of Western Europe. The Soviet Union's relative position does not change very much if the comparison is made on the basis of the amount of GNP generated per worker.

Imports from the West help in limited areas. For example, the USSR is presently finishing constructing a new automobile plant on the Volga. Essentially, this facility has been FIAT equipped, and when it operates, it will move the technological level of the Soviet automobile industry forward very sharply. But the plant will not reach maximum output until 1975, and by that time the car being turned out will be semi-obsolescent by Western standards. In other words, there will be virtually no Soviet follow through to keep the technology up to date, in 1975 they will still be turning out the 1969 FIAT.

These are not inexpensive moves. The FIAT plant will cost roughly \$1 billion, and a follow-up truck plant will cost at least as much. As you know, the USSR tried unsuccessfully to arrange a joint venture with Ford for the truck plant.

Accelerated technological progress is an attractive way for the USSR to speed up economic growth. The magnitude of the Soviet lag is so great as to hold out great promise in merely copying developments that have been pioneered and proven in the West.

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Closing the Technological Gap -- A Hopeless Chase?

Closing the technological gap -- of which the Soviet leadership is well aware -- is not an easy task. Technological progress as measured by the estimated annual increase in productivity has been slowing in recent years. Since the ability to acquire technology from the West, in the form of complete plants on a turn-key basis is limited by the availability of foreign exchange, the problem -- if it is to be solved -- evolves upon Soviet management. It is a task of altering the institutional means whereby new technology moves from the research stage through development and test to fruition in the form of completed plant.

Many articles have been written in Soviet journals on the kinds of organizational changes that could be made which would supposedly speed up the introduction of new technology. To date, however, the results of exhortation and suggestion have not been visible.

Diminishing Returns to Investment (Chart 7)

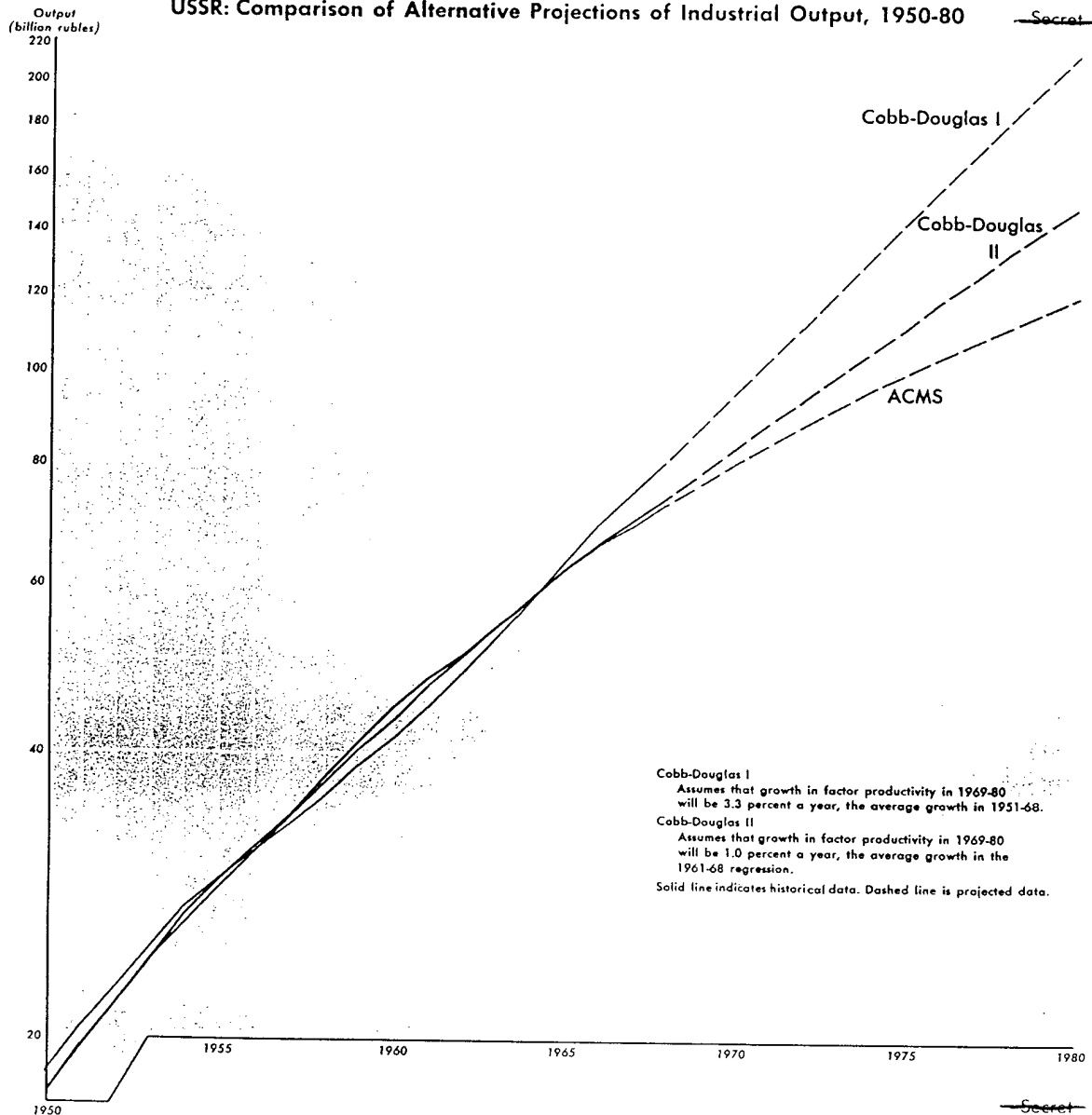
Our study of the changing relationships between inputs and output in the Soviet economy leads us to the conclusion that the country has been experiencing sharply diminishing returns on capital investment. The chart shows the plotted relationship over time.

In trying to achieve the highest possible volume of investment, Soviet economic policy has forced the capital-output

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USSR: Comparison of Alternative Projections of Industrial Output, 1950-80

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ratio continuously upward, and this strategy has accentuated the effect of diminishing returns.

If this calculated relationship holds true for the future, the continuation of capital and man-hours growth at the rate of the 1960's would result in a projected annual growth of about 4 percent (1970-80) compared to 7 percent in 1961-68 and about 8.5 percent in 1951-58 for the industrial sector. For any conceivable transfer of (capital) investment resources from defense to industry, the additional returns would not be enough to overcome the slowdown.

We have tentatively concluded that the Soviet leadership is unlikely -- at any time in the near future -- to face up to a wholesale overhaul of the economy. Tinkering with investment flows and organizational changes can be expected, but they are unlikely to restore fast growth.

Let me close by reiterating that slower economic growth clearly can provide the resources for an increasing military effort, a rising level of living, and an expanding industrial base. The Soviet economy is now so large that a very small rate of increase in GNP -- say 2 percent -- results in about \$9 billion more of product.

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